

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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In the Matter of)
)
1998 Biennial Regulatory Review --)
Review of Depreciation Requirements)
for Incumbent Local Exchange Carriers)
)
United States Telephone Association's)
Petition for Forbearance from Depreciation)
Regulation of Price Cap Local Exchange)
Carriers)

CC Docket No. 98-137

ASD 98-91

PETITION FOR RECONSIDERATION OF
U S WEST COMMUNICATIONS, INC.

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May 10, 2000

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TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION AND SUMMARY	2
II. FORBEARANCE FROM REGULATING THE DEPRECIATION RATES AND PRACTICES OF PRICE CAP LECS IS COMPELLED BY SECTION 10..	5
III. IN THE ALTERNATIVE, THE COMMISSION'S DEPRECIATION RULES SHOULD BE MODIFIED SIGNIFICANTLY TO REFLECT TODAY'S FAST-CHANGING HIGHLY-COMPETITIVE COMMUNICATIONS ENVIRONMENT.....	8
A. The Commission's Emphasis On Historical Retirements Has Resulted In The Adoption of Overly-Long Service Lives.....	10
B. The Commission Should Revise Its Waiver Requirements To Permit An Above-The-Line Amortization Over A Reasonable Period of Time....	14
IV. CONCLUSION	16

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U S WEST Communications, Inc. ("U S WEST"), through counsel and pursuant to Section 1.429 of the Federal Communications Commission's ("Commission") Rules, hereby requests that the Commission reconsider its decision in the above-captioned proceeding on depreciation requirements for price cap local exchange carriers ("LEC").¹

In this petition, U S WEST requests that the Commission, on reconsideration, grant the United States Telephone Association's (now known as United States Telecom Association) ("USTA") petition for forbearance.² In the

¹ See 1998 Biennial Regulatory Review -- Review of Depreciation Requirements for Incumbent Local Exchange Carriers; United States Telephone Association's Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers, Report and Order in CC Docket No. 98-137, Memorandum Opinion and Order in ASD 98-91, 15 FCC Rcd. 242 (1999) ("Order").

² See Petition for Forbearance of USTA, ASD 98-91, filed Sep. 21, 1998.

alternative, the Commission should significantly modify its Order³ in the Biennial Regulatory Review of depreciation including the Commission's methodology for determining equipment service lives for depreciation purposes and its depreciation waiver requirements.

I. INTRODUCTION AND SUMMARY

The Commission initiated this proceeding to satisfy the requirements of Section 11 of the 1996 Act which requires the Commission to review biennially its rules and to eliminate all unnecessary regulations.⁴ Numerous parties, including U S WEST, filed comments in response to the Commission's Notice and USTA filed a petition requesting that the Commission forbear from regulating the depreciation rates and practices of price cap carriers under Section 10 of the 1996 Act.⁵

On December 30, 1999, the Commission issued a joint Order addressing both its Notice along with the associated comments, and USTA's forbearance petition. The Commission denied USTA's request for forbearance and gave incumbent price cap LECs little, if any, relief from existing depreciation requirements -- despite claiming that its Order "greatly streamline[d] the depreciation requirements for price cap incumbent local exchange carriers."⁶ In dissenting, Commissioner

³ See Order, 15 FCC Rcd. 242.

⁴ See 47 U.S.C. § 161; see also In the Matter of 1998 Biennial Regulatory Review -- Review of Depreciation Requirements for Incumbent Local exchange Carriers, Notice of Proposed Rulemaking, 13 FCC Rcd. 20542 (1998) ("Notice" or "NPRM"). Comments and Reply Comments to the NPRM were filed on Nov. 23 and Dec. 8, 1998, respectively.

⁵ See USTA petition; see also 47 U.S.C. § 160.

⁶ Order, 15 FCC Rcd. at 243 ¶ 1.

Furchtgott-Roth stated that he would have granted USTA's forbearance petition because "the Commission's depreciation requirements no longer serve a useful purpose."⁷ U S WEST shares Commissioner Furchtgott-Roth's view as to the value of the Commission's existing depreciation rules under price cap regulation,⁸ and requests that the Commission grant USTA's petition for forbearance.

In its Biennial Regulatory Review Order, the Commission slightly expanded the range of lives for digital switching equipment from 16 to 18 years to 12 to 18 years.⁹ The Commission declined to shorten equipment lives for any other accounts and rejected both the projection lives and methodology recommended by Technologies Futures, Inc. ("TFI").¹⁰ In doing so, the Commission focused on TFI's unsurprising acknowledgment that "uncertainty is inherent in predicting plant

⁷ Order at Separate Statement of Commission Furchtgott-Roth, 15 FCC Rcd. at 278 ("Furchtgott-Roth Statement").

⁸ U S WEST shares the view that depreciation expenses are irrelevant for rate regulation purposes in today's price cap environment with the sole exception of the low-end adjustment mechanism. Other than this "slim thread," there is no reasonable basis for regulating the depreciation rates and practices of price cap LECs. Even the low-end adjustment, as Commissioner Furchtgott-Roth notes, is insufficient reason to continue pervasive depreciation regulation of price cap carriers when there are less burdensome ways of ensuring that price cap LECs do not abuse the low-end adjustment mechanism. See Furchtgott-Roth Statement, 15 FCC Rcd. at 278-80.

⁹ See Order, 15 FCC Rcd. at 247-48 ¶ 13.

¹⁰ See Transforming the Local Exchange Network: Analyses and Forecasts of Technology Change, by Lawrence K. Vanston, Ray L. Hodges and Adrian J. Poitras. © 1997, Technology Futures, Inc.; see also Ameritech Comments at 10; Cincinnati Bell Telephone Company Comments at 7-8; Southwestern Bell Telephone Company Comments at 21; U S WEST Comments at 10-13.

replacements”¹¹ and concluded “that the TFI study fails to establish convincingly that current projection lives are inadequate.”¹²

In addition to other relatively minor modifications in its depreciation rules, the Commission found that waiver of these rules would be appropriate under certain circumstances. Specifically, the Commission found that:

a waiver may be approved when an incumbent LEC, voluntarily, in conjunction with its request for waiver: (1) adjusts the net book costs on its regulatory books to the level currently reflected on its financial books by a below-the-line write-off; (2) uses the same depreciation factors and rates for both regulatory and financial accounting purposes; (3) foregoes the opportunity to seek recovery of the write-off through a low-end adjustment, and exogenous adjustment, or above-cap filing; and (4) agrees to submit information concerning its depreciation accounts, including forecast additions and retirements for major network accounts and replacement plans for digital central offices. Finally, the waiver request must comply with section 1.3 of the Commission’s rules.¹³

The Commission’s objective in adopting such stringent waiver conditions was to ensure that there was no possibility that price cap carriers could recover any portion of the difference between their regulatory net book costs and financial net book costs through higher customer rates or that shorter equipment lives could lead to increases in customer rates.

The requirement that any difference between a carrier’s regulatory and financial books be written-off below-the-line also ensures that any depreciation reserve deficiency will never be reflected in a carrier’s regulated rate of return --

¹¹ Order, 15 FCC Rcd. at 248-49 ¶ 15.

¹² Id. at 249 ¶ 16.

¹³ Id. at 252-53 ¶ 25.

regardless of the fact that the under-depreciated plant which created the reserve deficiency was used to provide regulated services.

If, on reconsideration, the Commission declines to grant USTA's forbearance petition, U S WEST alternatively requests that the Commission significantly modify its methodology for establishing service life ranges which is based almost exclusively on historical retirements. On reconsideration, the Commission should adopt a methodology such as that employed by TFI which incorporates forecasts of how fast new technology will replace embedded technology. Employing such an approach would allow the Commission to adopt service life ranges which reflect "economic" obsolescence, not merely "physical" obsolescence.

Additionally, U S WEST requests that the Commission revise its waiver conditions to restore a proper balance between shareholder and rate payer interests. The Commission's waiver requirements are of questionable legal validity since they are premised on a carrier making "voluntary" commitments to relinquish rights that it might have to recover depreciation expenses incurred in the provision of regulated services.

II. FORBEARANCE FROM REGULATING THE DEPRECIATION RATES AND PRACTICES OF PRICE CAP LECS IS COMPELLED BY SECTION 10

Section 10 of the 1996 Act directs the Commission to remove needless regulation and creates a strong presumption in favor of deregulation. Commissioner Michael K. Powell described the statutory obligation with respect to forbearance under Section 10 as follows:

I believe that under the congressional forbearance scheme, the Commission has an obligation to validate or justify continued regulation in light of competitive conditions and cannot discharge that burden by shifting complete responsibility to petitioners. It is becoming a pattern at this Commission to set its own malleable standards of proof in forbearance cases and then sit back and summarily dismiss petitions for lack of proof. I believe Section 10 requires more. It requires the Commission to come down from on high and itself accept responsibility for demonstrating with some rigor why continued regulation is justified. It requires us to get our hands dirty.¹⁴

Commissioner Powell is correct. The Commission has an *affirmative duty* under Section 10 to determine, “not whether forbearance is warranted, but whether the challenged regulation is warranted any longer.”¹⁵

Commissioner Powell’s insightful analysis into the meaning of Section 10 demonstrates that the Commission has the burden to justify continued regulation. He noted that Section 10 directs the Commission to “determine” and “consider” the three statutory criteria and states that the Commission “shall” forbear if it determines that these criteria are satisfied. “These words suggest that the Commission has an affirmative duty to work through, not whether forbearance is warranted, but whether the challenged regulation is warranted any longer,” Powell stated.¹⁶ “For if it is not, forbearance is mandated as a matter of law.”¹⁷

¹⁴ In the Matter of Policy and Rules Concerning the Interstate Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as Amended, Petitions for Forbearance, Memorandum Opinion and Order, 14 FCC Rcd. 391 (1998) at Dissenting Statement of Commissioner Michael K. Powell, rel. Jan. 28, 1999 at 4 (footnote omitted) (“Powell Dissenting Statement”).

¹⁵ Id. at 4

¹⁶ Id.

¹⁷ Id.

Accordingly, the presumption is in favor of forbearance, not regulation, and the proponents of continued regulation (including the Commission) bear a heavier burden of proof under Section 10.

Despite the plain language of Section 10, the Commission “too often asks petitioners to disprove a hit parade of merely speculative harms while opponents of forbearance seem to be granted the benefit of the doubt.”¹⁸ Clearly, this appears to be the case with respect to USTA’s petition. Consistent with the pro-competitive, deregulatory intent of the 1996 Act, Commissioner Powell suggests that once carriers make a prima facie case that the regulation is unnecessary, the burden should shift to the Commission to determine whether continued enforcement of a regulation or statutory provision is still necessary under the statutory criteria of Section 10.¹⁹

There is no doubt that USTA’s petition establishes a prima facie case that the Commission should forbear from subjecting price cap LECs to depreciation regulation. In denying USTA’s petition, the Commission has not met its burden of proof under Section 10 of the 1996 Act. This is demonstrated by the fact that the Commission found continued regulation of depreciation is necessary on the basis of a number of “speculative,” though unlikely, outcomes. On reconsideration, the Commission should correct its mistake and grant USTA’s petition.

¹⁸ Id. at 5-6.

¹⁹ Given the Commission’s reluctance to exercise its statutory forbearance authority, Commissioner Powell’s burden-shifting approach is eminently sensible and consistent with Section 10.

III. IN THE ALTERNATIVE, THE COMMISSION'S DEPRECIATION RULES SHOULD BE MODIFIED SIGNIFICANTLY TO REFLECT TODAY'S FAST-CHANGING HIGHLY-COMPETITIVE COMMUNICATIONS ENVIRONMENT

The Commission's Section 11 Biennial Regulatory Review of depreciation finds little if any "regulation [that] is no longer necessary in the public interest as a result of meaningful economic competition between providers of such [telecommunications] service."²⁰ The regulatory relief offered by the Order is, at best, minimal. The Order failed to: (1) simplify depreciation calculations; (2) recognize that technological obsolescence is driving asset lives -- not historical retirements; (3) recognize the impact of competition on the speed in deploying new and advanced technologies; and (4) recognize that good financial practices protect both shareholder and customer interests.²¹

²⁰ 47 U.S.C. § 161(a)(2).

²¹ Throughout its Order, the Commission implies that shareholder and consumer interests are incompatible and that the Commission must adopt separate "financial" rules to protect consumer interests. There is adequate evidence to demonstrate that shareholder and consumer interests are sufficiently similar and that specialized accounting practices are both unnecessary and counterproductive. Shareholders' interests, which are overseen by the Securities and Exchange Commission ("SEC"), are inaccurate and comparable financial information. Under- or overstating revenues, expenses or income may mislead investors and cause them to make inappropriate investment decisions. As a result, both shareholders and the SEC have an interest in accurate depreciation expense reporting.

Consumers' interests are in paying a fair price for telecommunications services. This ensures they will continue to receive the services they need while not being overcharged. Understating depreciation expense causes consumers to make purchase decisions that inappropriately favor certain technologies in the short term. In the long term, future consumers are harmed by paying a premium to make-up for the prior under-recovery. Additionally, carriers are incented to delay the deployment of new technology until they have recovered costs of older technology. Clearly, the 1996 Act contemplates that the correct economic signals will be sent to

The Order basically retains the status quo for price cap LECs by: (1) relying on depreciation methods and procedures that were developed 20 years ago; (2) assuming that LECs control the introduction of technology uninfluenced by competition or customer demands; (3) assuming that incumbent LECs and their competitors use the same communications equipment in such different ways, it is appropriate for incumbent LECs and their competitors to use widely disparate depreciation rates and service lives; (4) requiring price cap LECs continue to satisfy onerous recordkeeping requirements; and (5) continuing the fiction that the universal service fund will be harmed unless the Commission continues to understate average loop costs through inadequate depreciation rates.

On reconsideration, the Commission should abandon the faulty premise that consumers will be harmed if price cap LECs are allowed to conform their regulatory depreciation practices to their financial practices. This simply is not true.

Specifically, the Commission should: (1) adopt depreciation practices that take into account the increasing rate of technological change (and obsolescence); (2) eliminate its reliance on backward-looking historical retirements in projecting asset lives; and (3) allow LECs to adopt depreciation practices that are consistent with those used by their competitors.

both consumers and shareholders in order to stimulate new investment and competition.

A. The Commission's Emphasis On Historical Retirements
 Has Resulted In The Adoption of Overly-Long Service Lives

The Commission has relied almost exclusively on the use of historical retirement data in determining service lives for depreciation purposes.²² In doing so, the Commission has operated under the mistaken assumption that the use of historical retirement data leads to more accurate forecasts of service lives than a methodology such as that recommended by TFI, which attempts to forecast technology replacement patterns. This is not true.

Use of historical retirements largely ignores the recent impacts of competition and technological change on shortening service lives. Overemphasis on historical retirement data is particularly troublesome in a business such as the local exchange business which is capital intensive and where carriers have large amounts of embedded investment. The problem is further exacerbated by the fact that plant may remain on a LEC's books long after it has become economically obsolete -- simply because it is used to provide some small amount of service.

In order to understand the influence of historical retirements on service lives under the Commission's current methodology, it is most helpful to look at a few examples. The simplest analogy, albeit a vastly over-simplified analogy, is that of a new company that has a single asset -- a new automobile which cost \$30,000 and that lasts five years with no trade-in (salvage) value. In the first year, the company had to replace \$100 worth of parts on the automobile. If the company is using

historical retirement data (i.e., the life indication method) to establish the automobile's service life for depreciation purposes, it would estimate that the car will last 300 years (\$30,000/\$100) -- rather than five years. Continuing the automobile example through year 5, simplified with one year bands, assume the retirements were as follows:

	<u>Retirement</u>	<u>Remaining Investment</u>	<u>Historical Life Indication</u>
Year 1	\$ 100	\$29,900	300 years
Year 2	300	29,600	99.7
Year 3	1,000	28,600	29.6
Year 4	3,000	25,600	9.5
Year 5	25,600	0	

Obviously, this is an overly-simplistic example, but it does demonstrate that historical retirement data can skew the life indications of a depreciable asset. Needless to say, the calculations are not nearly as straight-forward for a LEC, such as U S WEST, which has a large number of assets purchased in a variety of years.

The timing of retirements has a significant impact on service lives when historical retirement data is used to establish lives. If retirements do not occur with regularity but are "lumped" near the end of the life of a technology, the use of historical retirement data will result in overly-long service lives. Furthermore, if massive retirements occur at the end of a technology life, but the new technology/equipment does not cause a one-for-one replacement (i.e., retirement) of the old technology, historically-based service lives will never reflect the true

²² The Commission's Order is replete with numerous references to historical retirements in supporting its findings. See Order, 15 FCC Rcd. at 247-49, ¶¶ 13, 14, 16, n.37.

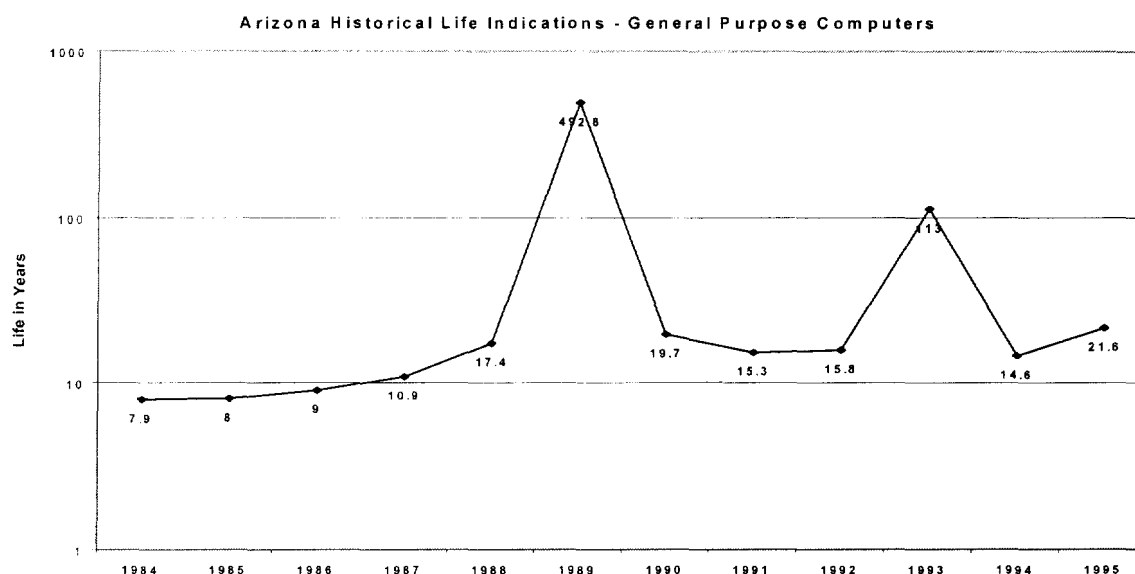
economic life of the equipment. A good example of this phenomena is copper cable which is being replaced as a means of transmission for many applications by fiber-optic cable and wireless transmission. One would expect that this growing substitution of fiber and wireless transmission would, and should, reduce the service life of copper cable. Despite the movement away from copper as a transmission medium, much of it remains in service even though it may carry less traffic. Since much of the copper cable continues to remain “in service,” the impact of substituting wireless and fiber-optic technology for copper cable will not be properly reflected in the service life of copper cable when lives are determined using historical retirement data.

Historical life indications are of little use in determining appropriate service lives for equipment that is subject to rapid technological change. While historical life indications provide information on past asset retirement patterns, they tell us nothing about how long assets will be used in the future.²³ Most of U S WEST’s assets (i.e., switching, circuit equipment and cable accounts) and those of other price cap LECs are experiencing unprecedented forces of technological change. As a result, historical life indications can be very misleading and harmful when used to establish service lives for depreciation purposes.

The following chart illustrates just how wrong life indications can be. This chart contains historical life indications for Arizona general-purpose computers

²³ Determining depreciation lives with historical life indications is like driving a highway using only the rear view mirror to navigate. By the time you have discovered that you have gone off a cliff, it is too late to take evasive action.

(using the Commission's historical life indication methodology with three-year bands). The results indicate that the life of these computers ranges from a low of 7.9 years to a high of 493 years. Needless to say, this is absurd. More often than not, computers are technologically obsolete in less than two years. In technology-driven accounts, such as computers, copper, circuit or switching equipment, historical life indications provide no useful information about the future.



Clearly, historical retirements should never be used as the basis for determining service lives when technological obsolescence is present or anticipated in the near future. In such situations it is critical that a forward-looking methodology, such as substitution analysis that incorporates realistic estimates of technological change, be used.²⁴ As such, on reconsideration, the Commission

²⁴ See Comments of U S WEST, CC Docket Nos. 96-45 and 97-160, filed June 1, 1998 at Attachment 3 Testimony of William R. Easton, Director, Capital Recovery, U S WEST, at Exhibit WRE-01, Depreciation Lives for Telecommunications Equipment: Review & Update at 12.

should abandon its current methodology, which relies too heavily on historical retirements, and adopt the methodology proposed by TFI, which more accurately reflects the rapidly-changing telecommunications environment in which price cap LECs operate.

B. **The Commission Should Revise Its Waiver Requirements To Permit An Above-The-Line Amortization Over A Reasonable Period of Time**

The Commission's Order offers no reasonable explanation why price cap carriers should be required to take a one-time below-the-line write-off in order to qualify for a waiver of the Commission's depreciation rules.²⁵ The Commission must be aware that it cannot lawfully require such a write-down associated with equipment that has been "used and useful" in the provision of regulated telecommunication services.²⁶

It is difficult, if not impossible, to justify such a below-the-line write-off after ratepayers have enjoyed the benefits of uneconomically low depreciation rates for decades. For the Commission to now require price cap LECs to "voluntarily" treat any depreciation reserve deficiency as if the investment had never been used to provision regulated telecommunications service is a fiction. There is no justification for suggesting that LECs forego recovering this expense long after capital has been invested to provide interstate service. Therefore, the Commission should recognize

²⁵ As was noted above and in the Furchtgott-Roth Statement, these rules are of questionable value in today's price cap environment.

²⁶ It has long been good law that expenses, such as depreciation, associated with prudent investments are allowable in utility ratemaking. See West Ohio Gas Co. v. Public Utilities Com., 294 U.S. 63, 72 (1935).

that there is no such thing as a “voluntary” requirement and revise its waiver criteria to reflect this fact.

A much more reasonable approach would be for the Commission to allow an above-the-line amortization over a five-year period, without conditions. There is little, if any, chance that this approach would affect price cap LECs’ rates and it would properly balance the interests of shareholders and ratepayers.²⁷ However, amortization expenses should be treated like any other lawful expenditure. If a combination of revenue shortfalls and other expenses push LEC earnings below the low-end adjustment, price cap LECs should be allowed to reflect this adjustment in the next annual tariff filing. This is far different from an exogenous adjustment which would immediately increase rates over the life of the amortization.²⁸

²⁷ Such an above-the-line amortization would also more accurately reflect price cap LECs’ rates of return (which LECs are required to provide under price cap regulation).

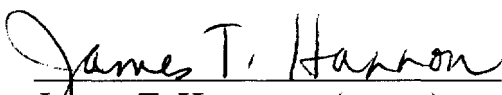
²⁸ While original price cap rates may have been set too low due to inadequate depreciation rates, U S WEST is neither requesting nor suggesting that amortization costs be reflected in an exogenous adjustment. However, under existing price cap rules it would be inequitable and unprecedented to disallow a certain category of expenses for purposes of determining whether the low-end adjustment is triggered.

IV. CONCLUSION

On reconsideration, the Commission should grant USTA's petition for forbearance. In the alternative, the Commission should revise its depreciation rules as discussed in the foregoing comments.

Respectfully submitted,

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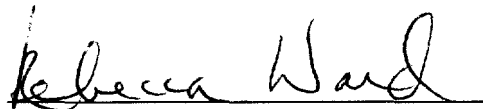
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Of Counsel,
Dan L. Poole

May 10, 2000

CERTIFICATE OF SERVICE

I, Rebecca Ward, do hereby certify that on the 10th day of May, 2000, I have caused a copy of the foregoing **PETITION FOR RECONSIDERATION OF U S WEST COMMUNICATIONS, INC.** to be served, via hand delivery, upon the persons listed on the attached service list.


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